tax IMPACT

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Nonqualified options

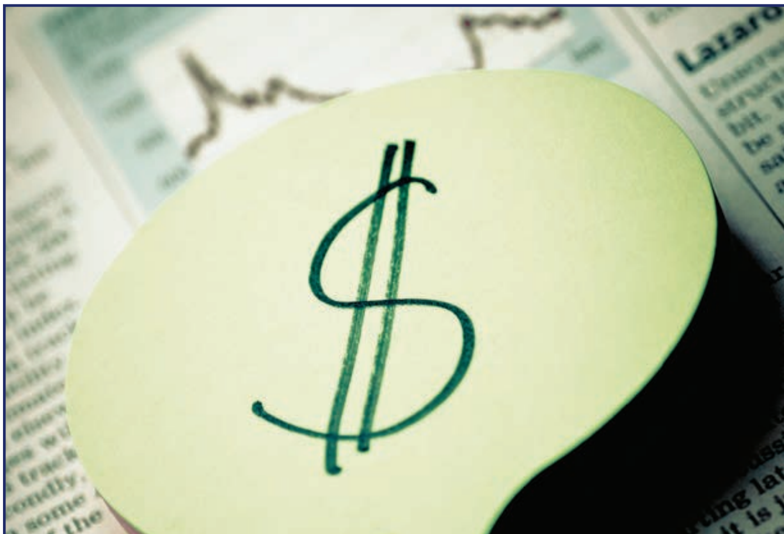
How to report stock sales

The tax treatment of nonqualified stock options (NSOs) is quite simple. Unfortunately, filling out the IRS forms can be complicated — especially since recent rule changes went into effect. Here are four things you should know about NSOs.

1. How NSOs work

An NSO is an option that doesn't qualify for the special tax treatment afforded incentive stock options (ISOs). Despite the potential tax advantages of ISOs, most employers use NSOs because they're simpler, their tax treatment is more straightforward, and they avoid certain risks and limitations associated with ISOs.

Let's look at an example: ABC Inc. grants its employee, Steve, NSOs to buy 100 shares of the company's stock for $100 per share — the fair market value (FMV) on the grant date. The options vest over five years and must be exercised within 10 years. In year 5, the stocks' FMV has increased to $150 per share, and Steve exercises all of his options, buying shares worth $15,000 (100 × $150) for $10,000 (100 × $100).



2. NSO tax treatments

Generally, there are no tax consequences when NSOs are granted. Publication 525's discussion of NSOs devotes several paragraphs to the circumstances under which an option grant requires you to report taxable income. This would be the case if the option itself (as opposed to the underlying stock) has "readily determinable value." But options granted by employers almost never satisfy this requirement.

Reporting income on the exercise of NSOs is a no-brainer. So long as the amount is reported properly on your W-2 or 1099-MISC, it should appear correctly on your tax return.

When you exercise an NSO, however, you must report compensation income equal to the spread between the exercise price and the stock's FMV on the exercise date. Going back to the example, when Steve exercises his options, he receives $5,000 in compensation, which is taxable to him as ordinary income and deductible by his employer. It's included in wages on Steve's Form W-2 and is subject to payroll taxes. In the case of a nonemployee, income from the exercise of NSOs would be reflected on Form 1099-MISC.

3. Basis for confusion

Reporting income on the exercise of NSOs is a no-brainer. So long

as the amount is reported properly on your W-2 or 1099-MISC, it should appear correctly on your tax return. Things get a bit more complicated, however, when you sell the stock. In theory, calculating and reporting gain on the sale of option stock is simple: You take the proceeds from the sale (net of any broker's commissions or other expenses) and subtract your basis in the stock.

The difference is short- or long-term capital gain, depending on how long you held the stock. Generally, the basis is equal to the amount you paid for the shares (the exercise price) plus the amount of compensation income you reported upon exercise.

Suppose Steve, from the example above, holds his stock for two years and sells it for $18,000. His basis is $15,000 — the original exercise price of $10,000, plus the $5,000 he reported as wages. When he sells the stock, he will recognize $3,000 in long-term capital gain.

But, here's the problem: When you sell stock your broker sends you a Form 1099-B and files it with the IRS. The form reports your proceeds from the sale and may also report your basis. But when a 1099-B relates to stock acquired through the exercise of NSOs, there's a good chance the basis amount is wrong.

The 1099-B instructions state, "If the securities were acquired through the exercise of a compensatory option, the basis hasn't been adjusted to include any amount related to the option that was reported to you on a Form W-2." But this may or may not be true.

4. Adjustments

Until recently, brokers were permitted, but not required, to adjust basis to reflect the amount of compensation income reported when options were exercised. For options granted after 2013, however, brokers are *prohibited* from making this adjustment. That means that, for options granted in 2014 or later, the basis entered on Form 1099-B will definitely be wrong — so you'll need to adjust it yourself. For options granted earlier, brokers are still permitted to make the adjustment, so you'll need to calculate the basis yourself to ensure you report the right amount of gain.

Do your homework

If you sell stock acquired through the exercise of NSOs, don't rely on the basis reported by your broker. If you do, and the basis wasn't adjusted, you'll overstate your gain (or understate your loss) and overpay your taxes. Determine the basis yourself and, if the amount in your 1099-B is wrong, correct it in your tax return. ◎

Correcting your basis

As explained in the main article, basis reported in a 1099-B may or may not have been adjusted to reflect amounts you reported as compensation income. If it wasn't adjusted, you'll need to correct it in your tax return.

On Form 8949 ("Sales and Other Dispositions of Capital Assets"), enter the sale proceeds in column (d), enter the basis from your 1099-B in column (e), enter the code "B" in column (f) (to indicate that the broker reported the wrong basis), and enter the adjustment amount in column (g). Note: The form asks for the adjustment to your *gain or loss*, not your basis. If you're increasing your basis, you'll enter a negative number here.

Should you treat a partner as an employee?

In today's competitive environment, offering employees an equity interest in your business can be a powerful tool for attracting, retaining and motivating quality talent. If your business is organized as a partnership, however, there are some tax traps you should avoid.

Once an employee becomes a partner, the IRS takes the position that you can no longer treat him or her as an employee for tax purposes. This has several significant tax implications, however.

Employment taxes

Employees pay half of the Social Security and Medicare taxes on their wages, through withholdings from their paychecks. The employer pays the other half. Partners, on the other hand, are treated as being self-employed — they pay the full amount of "self-employment" taxes through quarterly estimates.

Any employment taxes not *paid by the partnership on a partner's behalf are the partner's responsibility.*

Often, when employees receive partnership interests, the partnership continues to treat them as employees for tax purposes, withholding employment taxes from their wages and paying the employer's share. The problem with this practice is that, because a partner is responsible for the full amount of employment taxes, the partnership's payment of a portion of those taxes will likely be treated as a guaranteed payment to the partner.

That payment would then be included in income and trigger *additional* employment taxes. Any employment taxes *not* paid by the partnership on a partner's behalf are the partner's responsibility.

Treating a partner as an employee can also result in overpayment of employment taxes. Suppose your partnership pays half of a partner's employment taxes and the partner also has other self-employment activities — for example, interests in other partnerships or sole proprietorships. If those activities generate losses, the losses will offset the partner's earnings from your partnership, reducing or even eliminating self-employment taxes.

Unvested profits interests

Partnerships sometimes grant unvested profits interests to employees or other service providers. Generally, these interests aren't taxable until they vest. But if certain conditions are met, a safe harbor allows recipients to elect to pay the tax when the interest is granted rather than when it vests. Because profits interests often have low or zero value when granted, the election produces significant tax savings.

One of the conditions is that the partnership treat the recipient as the owner of the partnership interest for tax purposes from the grant date forward. But if you continue to treat recipients as employees for employment tax purposes, you'll likely disqualify them from the safe harbor.

Employee benefits

Partners and employees are treated differently for purposes of many benefit plans. For example, employees are entitled to exclude the value of certain employer-provided health, welfare and fringe benefits from income, while partners must include the value in their income (although they may be entitled to a self-employed health insurance deduction). And partners are prohibited from participating in a cafeteria plan.

Moreover, continuing to treat a partner as an employee for benefits purposes may trigger unwanted tax consequences or even disqualify a cafeteria plan.

Plan carefully

If your business is contemplating offering partnership interests to your employees, consider the tax implications and potential impact on your benefit plans. Also, consider techniques that allow you to continue treating partners as employees for employment tax purposes. For example, you might create a tiered partnership structure and offer employees of a lower-tier partnership interests in an upper-tier partnership. Because employees aren't partners in the partnership that employs them, many of the problems discussed above will be avoided. ◎

Understanding the pros and cons of a SCIN

Many estate planning techniques minimize or even eliminate gift and estate taxes when transferring assets to family members. Sometimes, the most powerful techniques will also have a significant drawback: mortality risk. A person must outlive the trust's term to realize the benefits. Thus, a self-canceling installment note (SCIN) may be appropriate for anyone in poor health who isn't expecting to reach his or her actuarial life expectancy.

How a SCIN works

To use a SCIN in estate planning, you sell your business or other assets to your children or other family members (or to a trust for their benefit) in exchange for an interest-bearing installment note. As long as the purchase price and interest rate are reasonable, there's no taxable gift involved.

So you can take advantage of a SCIN without having to use up any of your annual gift tax exclusions or lifetime gift tax exemption.

Generally, you can avoid gift taxes on an installment sale by pricing the assets at fair market value

and charging interest at the applicable federal rate. As discussed below, however, a SCIN must include a premium.

The "self-canceling" feature means that if you die during the note's term — which must be no longer than your actuarial life expectancy at the time of the transaction — the buyer (that is, your children or other family members) is relieved of any future payment obligations.

SCINs present the opposite of mortality risk: The tax benefits are lost if you live longer *than expected.*

A SCIN offers a variety of valuable tax benefits. For example, if you die before the note matures, the outstanding principal is excluded from your estate. This allows you to transfer a significant amount of wealth to your children or other family members tax-free. And any appreciation in the assets' value after the sale is also excluded from your estate.

You also can defer capital gains on the sale by spreading the gain over the note term. If you die before the note matures, however, the remaining capital gain will be taxed to your estate even though no more payments will be received. Finally, your children or other family members can also benefit because they may be able to deduct the interest they pay on the note.

Beware of the "premium"

Like most things in life, you can't get something for nothing. To compensate you for the risk that the note will be canceled and the full purchase price won't be paid, the buyers must pay a premium — in the form of either a higher purchase price or a higher interest rate. There's no magic number for this premium; the appropriate premium is a function of the age of the payee and the stated duration of the note. If the premium is too low, the IRS may treat the transaction as a partial gift and assess gift taxes.

Both types of premiums can work, but they may involve different tax considerations. If you add a premium to the purchase price, for example, a greater portion of each installment will be taxed to you at the more favorable capital gains rate, and the buyers' basis will be larger. On the other hand, an interest-rate premium can increase the buyers' income tax deductions.

But the premium also comes with some risk. In fact, SCINs present the opposite of mortality risk: The tax benefits are lost if you live *longer* than expected. If you survive the note's term, the buyers will have paid a premium for the assets, and your estate may end up *larger* rather than smaller than before.

Understand what you're getting into

Keep in mind that, by using a SCIN, you're taking a risk that you won't survive the installment note's term. Moreover, you can't take advantage of this strategy if you're terminally ill. Why? Because the IRS will likely view the transaction as a sham. But if your health is poor or your family has a history of shorter-than-average life expectancies, a SCIN may be a bet worth taking.

tax **TIPS**

Time for a cost segregation study?

Businesses that acquire, construct or substantially renovate buildings or other real property often enjoy significant tax benefits by conducting cost segregation studies. These studies apply engineering and tax accounting principles to identify building components that qualify for accelerated depreciation, allowing a business to reduce its current tax bill or claim a refund for missed depreciation deductions in previous tax years.

If you decided against a cost segregation study in the past — for example, because you felt that the potential benefits didn't justify the cost — it may be time to reconsider. The recently finalized tangible property regulations may enhance the benefits of a cost segregation study for some taxpayers.

Estate tax relief for family businesses

If a family business makes up a large portion of your wealth, you may worry that your heirs will be forced to sell all or a portion of the business to cover the estate tax bill. Fortunately, Internal Revenue Code Section 6166 provides some relief.

If the value of a qualifying closely held business interest exceeds 35% of your adjusted gross estate, your executor may defer the portion of your estate's taxes that are attributable to that interest for up to 14 years. The estate pays interest only for four years and then pays 10 annual installments of principal and interest.

To qualify for an estate tax deferral, you must meet certain ownership requirements and the business must conduct an *active* trade or business. Check with your advisors to see if your business meets these requirements. If it doesn't, it may qualify by increasing your ownership percentage or level of activity.

Reporting capital gains is easier than it used to be

Until recently, investors had to report details about capital gains and losses on IRS Form 8949. For heavy traders, this potentially meant a lot of work. In 2013, the IRS quietly changed the rules, although many people remain unaware of the change.

Under current rules, Form 8949 is *not* required for a transaction if 1) you received a Form 1099-B from your broker showing that basis was reported to the IRS (without any adjustments in box 1g); and 2) you don't need to make adjustments to the basis or type of gain or loss reported on Form 1099-B. For these transactions, you may aggregate gains and losses, and enter the totals on Schedule D.

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